THE INTEREST AND USURY PROVISIONS OF THE NATIONAL BANK ACT.

AS EARLY as 1791 Congress exercised its power to incorporate banking associations as instrumentalities for the conduct of the government's fiscal affairs [1] by authorizing the organization of the first bank of the United States.[2] The second United States bank obtained its charter in 1816.[3] Not until February 25, 1863, did Congress pass the "Act to provide a national currency secured by a pledge of United States stocks and to provide for the circulation and redemption thereof." [4] This law was repealed by a new act with the same title which, though based upon the preceding act, included certain changes and additions.[5] Further amendments were incorporated in the law by the Act of June 3, 1864, which provided that the same should thereafter be known as the National Bank Act.[6]

Merely to have created a national banking system, without at the same time devising means by which its integrity would be preserved, would have defeated the important governmental functions which the system was intended to perform. The governmental transactions authorized by the provisions of the act could not be expected to supply a revenue that would sustain the economic life of the banks. Consequently, Congress provided [7] a source of revenue by permitting the national banks to exercise, for their own advantage, the incidental powers necessary to carry on the business of banking, including the power to discount and negotiate promissory notes, drafts, bills of exchange, and other evidences of debt and the power to lend money on personal security. It is this business of the banks which, to use the language of the Supreme Court, constitutes their capacity to perform their functions as a machine for the money transactions of the government.

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[1] McCulloch *v.* Maryland, 4 Wheat. 316, 401; Osborn *v.* United States Bank, 9 Wheat. 738, 861.

[2] 1 Stat. 191, 192, c. 10.

[3] 3 Stat. 266, 269, c. 44.

[4] 12 Stat. 680.

[5] 13 Stat. 99.

[6] 18 Stat. 123.

[7] R. S., § 5136.

But a grant of such broad powers necessarily had to be limited by restrictions which would prevent the abuse of those powers; and Congress deemed it wise to guard against the evil of usury by placing certain limitations upon the rates of interest which might be charged by national banks.

The exaction of usurious interest could be provided against by imposing limitations upon the rate of interest, but no inflexible standard could be assumed because it was necessary to the existence of national banks that they should be able successfully to compete with the state banks in their respective localities; and the rates of interest in the several states varied widely. It is obvious that the usefulness of national banks, as governmental instrumentalities, would have been impaired had the same rate been fixed for all the national banks throughout the United States. Congress was able to secure the end desired without subjecting the national banks to insurmountable competition by enacting the following provision:[8]

> "Any association may take, receive, reserve, and charge on any loan or discount made, or upon any note, bill of exchange, or other evidence of debt, interest at the rate allowed by the laws of the State, Territory, or District where the bank is located, and no more, except that where by the laws of any State a different rate is limited for banks of issue organized under State laws, the rate so limited shall be allowed for associations organized or existing in any such State under this Title. When no rate is fixed by the laws of the State, Territory, or District, the bank may take, receive, reserve, or charge a rate not exceeding seven per centum, and such interest may be taken in advance, reckoning the days for which the note, bill or other evidence of debt has to run. And the purchase, discount, or sale of a bona fide bill of exchange, payable at another place than the place of such purchase, discount, or sale, at not more than the current rate of exchange for sight drafts in addition to the interest, shall not be considered as taking or receiving a greater rate of interest."

The Rate Permitted.

Though the effect of this section was to make the rate al-

[8] R. S., § 5197.

lowed by the laws of a state applicable to all national banks in that state, the state usury law has no application, except as permitted by Congress in the matter of fixing the rate of interest chargeable.[9] And the charging of the rate permitted by the laws of the state is the sole particular, so far as loans and discounts are concerned, in which national banks are placed upon an equality with natural persons.[10] It has been held that "fixed by the laws of the state" means "allowed by the laws of the state," and that where a state statute provides that parties may agree for any rate of interest whatever, national banks may likewise agree in writing for any rate.[11] But a national bank which compounds interest in a manner prohibited by the state law is guilty of usury, even though the total interest amounts to less than the maximum rate permitted by the state law.[12]

Through judicial construction, however, an inequality has arisen in the law which subjects the national banks to a serious disadvantage. The Supreme Court of the United States has held [13] that although natural persons in a state where no rate of discount is fixed by law, may reserve or pay any stipulated rate upon the discount of commercial paper, the national banks of that state engaging in such transactions are limited to a rate of seven per cent., because loans and discounts are expressly made subject to the same rate by the provisions of the statute.

Upon principle, it would seem that cases of purchase where the title to the paper is transferred by endorsement without recourse, or by mere delivery, should be distinguished from cases of straight discount when the transfer is made by an endorsement imposing the ordinary liability on the endorser; and the Supreme Court has intimated that this principle is sound.[14] The Circuit Court of Appeals however, in a subsequent case,[15] decided that the purchase of accepted drafts by a national bank from a broker, without his endorsement, at a greater reduction

[9] Farmers' and Mechanics' Nat. Bank *v.* Dearing, 91 U. S. 29.
[10] National Bank *v.* Johnson, 104 U. S. 271.
[11] Daggs *v.* Phoenix Nat. Bank, 177 U. S. 549.
[12] Citizens Nat. Bank *v.* Donnell, 195 U. S. 369.
[13] National Bank *v.* Johnson, *supra.*
[14] National Bank *v.* Johnson, *supra.*
[15] Danforth *v.* National State Bank, 48 Fed. 271.

than the lawful rate of interest constituted usury, and this decision has never been reversed and is binding upon national banks at the present time. National banks should not be placed at a disadvantage of this kind, as state banks have a large and profitable field for the purchase of commercial paper at a large discount, while the field is entirely closed to national banks. The law should be amended so as to permit national banks to make bona fide purchases of commercial paper at any rate of discount which is permitted to state banks and individuals.

The Penalty.

In imposing a penalty for the exaction of usury, Congress had to take into consideration, on the one hand, the evils resulting from usury and the need for a sufficiently severe penalty to prevent national banks from engaging in usurious practices, and, on the other hand, the fact that too severe penalties would cripple national banks to such an extent that they would not be able properly to perform their duties as governmental agencies. The outcome of this was the enactment of Section 5198 of the Revised Statutes, which reads as follows:[16]

> "The taking, receiving, reserving, or charging a rate of interest greater than is allowed by the preceding section, when knowingly done, shall be deemed a forfeiture of the entire interest which the note, bill or other evidence of debt carries with it, or which has been agreed to be paid thereon. In case the greater rate of interest has been paid, the person by whom it has been paid, or his legal representative, may recover back in an action in the nature of an action of debt, twice the amount of the interest thus paid from the association taking or receiving the same; provided such action is commenced within two years from the time the usurious transaction occurred. That suits, actions and proceedings against any association under this Title may be had in any circuit, district, or territorial court of the United States held within the district in which such association may be established, or in any State, county or municipal court in the county or city in which said association is located having jurisdiction in similar cases."

[16] (As amended 1875).

Two separate and distinct classes of cases are contemplated by this section: First, those where usurious interest has been taken, received, reserved or charged, in which case there is a forfeiture of the entire interest which the note, bill or other evidence of debt carries with it, or which has been agreed to be paid thereon; Second, those where usurious interest has actually been paid, in which case the person paying it may recover back twice the amount of the interest thus paid from the association taking or receiving the same.[17] While the first clause refers to interest taken and received as well as that reserved or charged, the latter part of the clause apparently limits the forfeiture to such interest as the evidence of debt carries with it, or which has been agreed to be paid, in contradistinction to cases in which interest is actually paid, that being covered by the second clause of the section.[18]

INTEREST CHARGED BUT NOT ACTUALLY PAID.

The first penalty is incurred where the greater rate is taken, received, reserved, or charged, but not actually paid, and the forfeiture is of the entire interest, and not merely of the excess over the legal rate.[19] But the loss of the entire debt is not incurred.[20] The forfeiture includes the interest which accrues after the maturity of the note,[21] and is not waived by the giving and accepting of renewal notes including the usurious interest.[22] The forfeiture also includes the interest on renewal notes, if the illegal interest is incorporated as a part of the new principal, even though the renewal notes bear interest at the legal rate.[23]

Where interest greater than the legal rate has been charged, it may be relinquished and recovery had at the legal rate.[24]

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[17] Hazeltine *v.* Central Bank, 183 U. S. 132; Brown *v.* Marion Nat. Bank, 169 U. S. 416.

[18] Brown *v.* Marion Nat. Bank, *supra;* Hazeltine *v.* Central Bank, *supra.*

[19] Lake Benton First Nat. Bank *v.* Watt, 184 U. S. 151; McCarthy *v.* First Nat. Bank, 223 U. S. 493.

[20] Farmers' and Mechanics' Nat. Bank *v.* Dearing, *supra;* In re Wilde's Sons, 133 Fed. 562.

[21] First Nat. Bank *v.* Stauffer, 1 Fed. 187.

[22] Brown *v.* Marion Nat. Bank, *supra.*

[23] Farmers' and Mechanics' Nat. Bank *v.* Hoagland, 7 Fed. 159.

[24] Talbot *v.* Sioux City First Nat. Bank, 185 U. S. 172.

But where usury has been pleaded the forfeiture of all interest cannot be avoided by the declaration at that late day of an election to remit the excess.[25]

Where usury is charged the entire interest is forfeited, and a payment made without direction as to its application cannot be applied in payment of the forfeited interest.[26]

The statute of limitations cannot be interposed as a defense to the forfeiture of interest.[27]

Interest Actually Paid.

The second penalty imposed by Section 5198 is incurred when the illegal interest is actually paid. The payment must have been actual,[28] and it must have been *knowingly* received, or collected by the national bank in order to give rise to the liability for the double penalty.[29] The including of usurious interest as principal on a renewal note does not constitute payment;[30] nor is the reservation or deduction of usurious interest in advance sufficient to constitute actual payment, since it is not made by the debtor.[31] The payment of a judgment for the principal sum and legal interest rendered under the state law is not sufficient payment to give a cause of action for the double penalty, even though the illegal interest was charged but the excess deducted by the court in rendering judgment. The payment of illegal interest was not actually made and the second penalty was not invoked.[32]

The recovery is twice the entire amount of interest paid and not merely twice the excess over the legal rate.[33] But the en-

[25] Citizens Nat. Bank *v.* Donnell, *supra.*

[26] Danforth *v.* National State Bank, *supra.*

[27] McCarthy *v.* First Nat. Bank, *supra.*

[28] First Nat. Bank *v.* Lasater, 196 U. S. 115.

[29] Washington-Alaska Bank *v.* Stewart, 184 Fed. 673; Schuyler Nat. Bank *v.* Bolling, 24 Neb. 821; Garfinkle *v.* Bank of Charleston, 79 S. C. 404; Henderson Nat. Bank *v.* Alves, 91 Ky. 142.

[30] Brown *v.* Marion Nat. Bank, *supra;* Daingerfield Nat. Bank *v.* Ragland, 181 U. S. 45; First Nat. Bank *v.* Lasater, *supra;* Louisville Trust Co. *v.* Kentucky Nat. Bank, 87 Fed. 143.

[31] McCarthy *v.* First Nat. Bank, *supra.*

[32] Talbot *v.* Sioux City First Nat. Bank, *supra.*

[33] Lake Benton First Nat. Bank *v.* Watt, *supra;* Hill *v.* National Bank, 15 Fed. 432; Louisville Trust Co. *v.* Kentucky Nat. Bank, *supra.*

tire interest must have been actually paid by the plaintiffs.[34] Interest paid on renewal notes is included in estimating the double penalty, even though the payments made after the maturity of the note were at the legal rate.[35]

The right to bring an action of debt against the bank for the recovery of twice the amount of interest actually paid, is exclusive. The debtor has no other remedy, and the penalty imposed by a state statute does not apply.[36] The payment of usurious interest cannot be applied by way of offset or counterclaim in a suit by the bank to enforce the obligation;[37] and, as the principal debtor can make no application by way of offset or counterclaim, neither can the surety.[38] The payment of illegal interest cannot be asserted as a defense in proceedings brought under state law to foreclose collateral,[39] nor is the payment of illegal interest available as a defense to an equitable proceeding to collect the debt from collateral.[40]

Only the party actually paying the usurious interest, or his legal representative, can enforce the second penalty of double the amount paid.[41] Thus, one of the joint makers of a note cannot recover the penalty where the illegal interest is paid by the other maker.[42] It has been held [43] that an assignee for benefit of creditors under a state statute was a legal representative and, therefore, was entitled to maintain an action to recover the two-fold penalty; but considerable doubt was cast upon this

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[34] Knapp *v.* Williamsport Nat. Bank, 15 Fed. 333.

[35] Louisville Trust Co. *v.* Kentucky Nat. Bank, *supra.*

[36] Barnet *v.* National Bank, 98 U. S. 555; Driesbach *v.* National Bank, 104 U. S. 52; Stephens *v.* Monongahela Bank, 111 U. S. 197; Hazeltine *v.* Central Bank, *supra;* Schuyler Nat. Bank *v.* Gadsden, 191 U. S. 451; Farmers' and Mechanics' Bank *v.* Hoagland, *supra;* Cox *v.* Beck, 83 Fed. 209.

[37] Barnet *v.* National Bank, *supra;* Drusbach *v.* National Bank, *supra;* Hazeltine *v.* Central Bank, *supra;* Farmers' and Mechanics' Bank *v.* Hoagland, *supra.*

[38] Stephens *v.* Monongahela Bank, *supra.*

[39] Schuyler Nat. Bank *v.* Gadsden, *supra.*

[40] Cox *v.* Beck, *supra.*

[41] Knapp *v.* Williamsport Nat. Bank, *supra;* Timberlake *v.* First Nat. Bank, 43 Fed. 231.

[42] Timberlake *v.* First Nat. Bank, *supra.*

[43] Louisville Trust Co. *v.* Kontucky Nat. Bank, *supra.*

conclusion in a subsequent case.[44] Yet the latter case followed the former decision. A trustee in bankruptcy, however, is unquestionably the legal representative of a bankrupt, and may maintain an action to enforce the double penalty when the illegal interest was paid by the bankrupt.[45]

The petition must show that the action was commenced within two years from the time the usurious transaction occurred, or from the time the wrong was discovered.[46] And the recovery is limited to twice the amount of usurious interest paid during the two years next preceding the commencement of the action.[47] The two year limitation begins to run from the time the usurious interest was actually paid, and not from the time when it was agreed that it should be paid,[48] nor from the time of payment of the principal of the note,[49] nor from the time that the note was executed.[50]

National banks having charged usury, may, by the refusal to accept payment of illegal interest when tendered, show a disinclination to execute an illegal contract and thus escape liability for the double penalty.[51] But not so as to the forfeiture of interest under the first clause. There is no *locus penitentiae*, however, when the debtor actually pays and the national bank knowingly receives usurious interest, and a national bank cannot escape the double penalty by returning the interest thus received.[52]

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[44] Louisville Trust Co. *v.* Kentucky Nat. Bank, *supra.*

[45] Reed *v.* American-German Nat. Bank, 155 Fed. 233.

[46] Talbot *v.* Sioux City First Nat. Bank, *supra.*

[47] First Nat. Bank of Charlotte *v.* Morgan, 132 U. S. 141.

[48] Daingerfield Nat. Bank *v.* Ragland, *supra;* McCarthy *v.* First Nat. Bank, *supra.*

[49] McCarthy *v.* First Nat. Bank, *supra.*

[50] Louisville Trust Co. *v.* Kentucky Nat. Bank, 87 Fed. 143; 102 Fed. 442.

[51] McCarthy *v.* First Nat. Bank, *supra.*

[52] McCarthy *v.* First Nat. Bank, *supra.*